Internal Revenue Service

memorandum

CC:TL-N-1482-93
CORP:WHBaumer

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to: J. R. Bistline, Case Manager 4301 NWSAT
Dallas District

from: Assistant Chief Counsel (Field Service) CC:FS

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subject: Request for Field Service Advice
[redacted] and [redacted]

This is in response to your request of November 17, 1992, asking us to comment on the taxpayers' argument in their protest letter. The taxpayers argues that [redacted]'s interest in her trust, the [redacted] cannot be valued on the basis of recognized actuarial principles and therefore she should be deemed to have a zero percent interest in the trust for purposes of I.R.C. § 318(a)(2)(B)(i), rather than a 100 percent interest as we suggested before in our memorandum of February 11, 1992.

If the taxpayers are correct, then the stock of [redacted] ("[redacted]") which is owned by the [redacted] would not be attributed to [redacted]. Under such circumstances, there would be no attribution of her interest to her children with the result that I.R.C. § 304 would not apply and, therefore, there would be no dividend distribution to her family members.

ISSUE

Whether a 100 percent life interest in a discretionary trust coupled with a general power of appointment (with a provision providing that the property should go to the beneficiary's heirs upon default) should be considered an interest that can be computed on an actuarial basis within the meaning of I.R.C. § 318(a)(2)(B)(i).

CONCLUSION

The interest of a beneficiary in a trust, who holds 100 percent of the life estate and a general power of appointment, is an interest that can be valued actuarially. The Service makes such valuations under I.R.C. § 2041 on a regular basis. Unlike grantees of a special power of appointment, the potential grantees of a general power are not considered beneficiaries of the trust for federal tax purposes. As a consequence, there is no need in this case to apportion the value of the trust among several beneficiaries, since [redacted] was and is the sole beneficiary of the [redacted].

FACTS

Article III of the Articles of Agreement and Declaration of Trust of the [redacted] provides as follows:

> Section 1: The beneficiary shall have no rights to the corpus of the trust property, whether real, personal or mixed, nor shall she have a right to call for a partition or division of the same or dissolution of the trust, and the beneficiary shall have no right with respect to said Trust other than to receive distribution of net earnings awarded her by the Trustee with consent of the Advisory Board, as is elsewhere herein provided, and the right of distribution of said Trust Estate made by the Trustee at the termination of the Trust hereby created, whether at the expiration of the period fixed for its existence or by voluntary dissolution, it being fully understood and agreed that absolute control, dominion over, and the right to dispose of said property, income, revenue and proceeds thereof, so held in trust by said Trustee, is hereby vested in said Trustee and his successors, subject only to the express provisions hereof, during the period of his trusteeship, as herein defined.
>
> Section 2: The death, insolvency or bankruptcy of the Beneficiary hereunder, or the transfer of her interest in any manner, or by descent or otherwise, during the continuance of this Trust, shall not operate as a dissolution of, nor terminate the Trust, nor shall it have any effect whatever upon said Trust Estate, its operation or mode of business, nor shall it entitle her heirs or assigns or representatives to take any action in the courts of law or equity against the Estate, its Trustees or property or its business operations of any kind, all of which shall remain intact and undisturbed thereby: but they shall succeed only to the rights of the original Beneficiary as herein set forth.
>
> Section 3: At the time of the death of the Beneficiary, her equitable interest in said Trust Estate, unless disposed of otherwise by said Beneficiary, shall pass to and vest in her heirs in accordance with the laws of descent and distribution then in force, applicable to the equitable interest of such Beneficiary in said Trust Estate.

DISCUSSION

I.R.C. § 318(a)(2)(B)(i) provides that stock owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

Treas. Reg. § 1.318-3(b) provides that "for the purpose of section 318(a)(2)(B) stock owned by a trust will be considered as being owned by its beneficiaries only to the extent of the interest of such beneficiaries in the trust. Accordingly, the interest of income beneficiaries, remainder beneficiaries, and other beneficiaries will be computed on an actuarial basis."

It is well established law that a beneficiary of a trust holding an undivided interest in such trust owns a proportionate interest in the stock of the trust for purposes of the attribution rules. See Metzger Trust v. Commissioner, 693 F.2d 459, 451 (5th Cir. 1982), aff'g 76 T.C. 42 (1981); Haft Trust v. Commissioner, 510 F.2d 43, fn. 2 (1st Cir. 1975), aff'g 61 T.C. 398 (1973) and 62 T.C. 145 (1974); Sawelson v. Commissioner, 61 T.C. 109, 114 (1973); and Nutil v. United States, 69-1 U.S.T.C. ¶ 9229 (C.D. Cal. 1968).

The thrust of I.R.C. § 318(a)(2)(B)(i) is to allocate the stock in a trust in proportion to the beneficiaries' interests. When life estates and remainder interests are involved, Treas. Reg. § 1.318-3(b) provides that the proportionate interest of several beneficiaries will be computed on an actuarial basis, using the factors and methods prescribed in Treas. Reg. § 20.2031-7. See, for example, PS-100-88, 1992-47 I.R.B. 16. Unfortunately, the estate tax regulations assume that the trustees are required to distribute income and principal between specified persons. As a consequence, the question has arisen as to how to value discretionary trusts, under which the trustees have the discretionary power to select the recipients of trust income from among the members of an identified class.

Valuation of Life Estates in a Discretionary Trust

In the instant case, [redacted] is the life tenant of a discretionary trust. She also has a general power of appointment. For the moment, we shall concentrate on the conceivable approaches for valuing her life estate.

One author has suggested that there are three basic approaches for valuing a life tenant's interest in a discretionary trust. See Kanter, IRS Takes Novel Approach to Trust Attribution, 73 Journal of Taxation 420 (Dec. 1990). The first approach is to assume that the beneficiary's interest is purely speculative and therefore should be assigned a zero value. This was the approach taken in Rev. Rul. 67-53, 1967-1 C.B. 265 (where a trustee possesses the power, in his absolute and uncontrolled discretion, to pay out net income to the income beneficiary of a trust or to accumulate such income, the beneficiary's interest cannot be valued according to recognized valuation principles as of the date of the transferor's death).

The approach taken by Rev. Rul. 67-53 was approved by the district court in Boryan v. United States, 690 F. Supp. 459 (E.D. Va. 1988). In Estate of Weinstein v. United States, 820 F.2d 201 (5th Cir. 1987), the Sixth Circuit modified this approach for situations where the trustee's discretionary power was subject to a standard established in the trust instrument, namely an intention that

the wife be adequately provided for. In such cases, the court concluded that the beneficiary's interest could be valued on the basis of recognized valuation principles.

A second approach is to assume that the trustee will exercise his maximum discretion in favor of a beneficiary. Under this approach, each beneficiary could be deemed to own as much as 100 percent of the stock held by the trust. This approach has been used only when authorized by statute. For example, I.R.C. § 414(c), as interpreted by Treas. Reg. § 1.414(c)-2(b)(2)(ii), provides for such assumed exercise of discretion, as does I.R.C. § 1563(e)(3)(A).

The third approach to valuing a life tenant's interest in a discretionary trust is to extrapolate future income distributions on the basis of past distributions. This was the approach taken in PLR 9014076, CC:P&SI:5 (March 21, 1990). The foregoing treatment is based on the fact that actuarial science is not an exact science but rather depends on the exercise of judgment by the actuary as to how statistics based on studies of the past should be applied to future expectations. See Anderson, Actuarial Evidence p. 11 (1983 ed.). For example, the value of an employee's future income stream would have to take into account such factors as the rate of inflation, the appropriate interest discount, the possibility that the employee might resign or that the company might fail, and the possibility that the employee might not survive to retirement age. Generally speaking, the actuary will try to anticipate as many contingencies as possible and make appropriate allowance for them if he can find a statistical or logical basis for doing so.

As can be seen from the above, valuation of life estates in a discretionary trust is a muddled area. If [redacted] had no more than a life estate in her trust, we might well agree with the taxpayers that her interest was not susceptible to valuation by recognized actuarial methods. Fortunately, [redacted]'s interest in her trust is also composed of a general power of appointment.

Valuation of a General Power of Appointment

It is well recognized that general powers of appointment can be valued using recognized actuarial methods. I.R.C. § 2041(a)(2) specifically contemplates inclusion of such interests in the estate of the decedent. In addition, I.R.C. § 2056(b)(5), dealing with the allowance of the marital deduction, recognizes that life estates coupled with a power of appointment can be valued; such value is generally deducted from the value of the decedent's estate. The reason that such interests can be valued is that a life estate with a general power of appointment is an estate tantamount to a fee. See Ellis v. United States, 280 F. Supp. 786 (D. Md. 1968). The major issues under I.R.C. § 2041 have not related to valuation, but rather have involved questions involving disclaimer or have involved powers that were not general powers of appointment. See, for example, Goudy v. United States, 86-2 U.S.T.C. ¶ 13,690 (D. Oreg. 1986); and Martin v. United States, 780 F.2d 1147 (4th Cir. 1986).

According to the report of the House Ways and Means Committee in its recommendation regarding the predecessor of I.R.C. § 2041:

> A person having a general power of appointment is, with respect to disposition of the property at his death, in a position not unlike that of its owner. The possessor of the power has full authority to dispose of the property at his death, and there seems to be no reason why the privilege which he exercises should not be taxed in the same degree as other property over which he exercised the same authority.

H.R. Rep. No. 767, 65th Cong., 2d Sess., at 21 (1919).

If [redacted] possessed a special power of appointment, as opposed to a general power of appointment, the taxpayers' argument here might well have some validity. In such case, it would be necessary to value the beneficiaries' interests and to measure that interest against the value of [redacted]'s life estate. See, for example, Drummond v. Cowles, 278 F. Supp. 546 (D. Conn. 1968). The first problem, in such case, would be the identification of the heirs. Under section 3 of the Texas Probate Law, heirs denote those persons, including the surviving spouse, who are entitled under the statutes of descent and distribution to the estate of a decedent who dies intestate. Section 38 of the Texas Probate Law defines the interests of those persons who take upon intestacy.

Because of the Texas Probate Law, the heirs here are an undefined class since [redacted] could remarry or, conceivably, adopt children. In such case, the property distribution to each beneficiary would be unknown. In Rev. Rul. 70-567, 1970-2 C.B. 133, plaintiffs in a similar situation, were not taxed on income earned from an escrow account until they were determined to be entitled to receive the escrowed funds. The net result of the above, is that neither the life estate nor the remainder interests could be valued in accordance with recognized actuarial methods.

In the case of a general power of appointment, however, the result is completely different from that of a special power of appointment. Although neither the discretionary life estate nor the general power of appointment attached to that interest may be capable of valuation, when there is only one beneficiary, any income accumulated by the trustee will necessarily become part of the general power of appointment. As a consequence, a single beneficiary of a discretionary trust holding both the life estate and a general power of appointment, will be considered as owning 100 percent of the trust for purposes of I.R.C. § 318(a)(2)(B)(i).

Valuation of Powers of Appointment Containing Default Provisions

Our position in this case is based on a conclusion that [redacted] was and is the sole beneficiary of the [redacted] Taxpayers' position, on the contrary, is based on their conclusion that [redacted]s heirs (presently her children) currently possess a remainder interest in the trust. If this were so, we would be confronted with the problem of apportioning ownership in the trust between the beneficiaries (the mother and her heirs) in proportion to the actuarial value of each interest. The existence of the trustee's discretion to make income distributions to the mother (the life tenant) would appear to preclude an actuarial valuation (in accordance with recognized actuarial principles) of either the life tenant or the remainderman's interest.

The taxpayer is apparently relying on section 3.05 of Rev. Proc. 77-37, 1977-2 C.B. 568, to make such argument. The language therein was originally adopted in Rev. Proc. 68-32, 1968-2 C.B. 918. Section 3.05 provides as follows:

> In determining such ownership to be attributed to a trust or from a trust under the rules of section 318(a)(2)(B)(i) and 318(a)(3)(B)(i) of the Code in those cases where a surviving spouse is entitled to all the income for life from the trust and also holds a power of appointment over the corpus of the trust, and in default of the exercise of the power the property held by the trust is to pass to the children of the surviving spouse, attribution will be computed as if the surviving spouse has exercised the power in favor of his or her children, so that they will be considered beneficiaries in the absence of evidence that the power has been differently exercised.

It should be noted that, under section 2.03 of Rev. Proc. 77-37, the foregoing operating rule is provided solely to provide assistance to taxpayers in preparing ruling requests and is not meant to be a substantive rule. Accordingly, we believe that section 3.05 of Rev. Proc. 77-37 is not authority for the taxpayers' position. Section 2.03 provides as follows:

> These operating rules are being published solely to provide assistance to taxpayers and their representatives in preparing ruling requests. These operating rules do not define, as a matter of law, the lower limits of "continuity of interest" or "substantially all of the properties"; nor do they define any other terms used in the Internal Revenue Code, Income Tax Regulations and prior Revenue Procedures discussed below.

We have examined the file behind Rev. Proc. 68-32. The file indicates that the revenue procedure adopts, for advance ruling purposes, "the realistic view of regarding the children as beneficiaries based upon the implied assumption that the surviving spouse will exercise the power in his or her favor." Moreover, the file also concludes that it is unlikely that the spouse would exercise the power in favor

of someone other than his or her children, because the children would ordinarily be the natural object of his or her bounty.

The aim of Rev. Proc. 68-32 was to correct a perceived abuse involving the waiver of attribution rule for complete terminations under I.R.C. § 302(b)(3). The scenario addressed was one in which the outstanding stock of a corporation was owned by H and his wife W, his son, S, and S's minor children. Upon H's death, pursuant to his will, his stock and certain other property was placed in a trust for W, all the income of which was payable to W during her lifetime. The trustee had no power to make distributions for anyone else's benefit. W was also given a general testamentary power of appointment over the trust corpus, exercisable only by her. If W failed to exercise her power of appointment, the trust corpus would pass to S for his life and upon S's death to S's children. The corporation redeemed all the stock held by W and by her trust. W filed a waiver of family attribution agreement as described in I.R.C. § 302(c)(2)(A)(iii).

The issue addressed in Rev. Proc. 68-32 was whether the stock of S and S's children could be attributed to the trust, pursuant to the rule of I.R.C. § 318(a)(3)(B)(i), which attributes ownership from a beneficiary to a trust. It was perceived that since W was likely to be considered the sole beneficiary of the trust, the trust would avoid attribution from S and S's children and thus the trust would qualify for sale or exchange treatment under I.R.C. § 302(b)(3) even though its likely recipient, S, and S's children were stockholders. This attribution avoidance was apparently perceived as abusive. The Service attempted to thwart this perceived abuse by providing an operating rule that would have to be satisfied in order to obtain an advance letter ruling.

Despite any inferences one might draw from Rev. Proc. 68-32, we believe that the instant situation is distinguishable from the situation described therein. Where a decedent bequeaths a life estate to his surviving spouse along with a general power of appointment but provides that, in the absence of the exercise of such power, the corpus will go to their children by default, it might be argued that it is a foregone conclusion that the children will get the remainder interest in accordance with the decedent's wishes. As such, it can be argued that the children currently possess a remainder interest, subject to a condition subsequent (i.e., that their mother does not exercise her power).

In the instant case, it is not a foregone conclusion that [redacted]'s children will get the remainder interest. The trust agreement provides that, absent exercise of the power, the beneficiary's interest in the trust will pass to her heirs under the local laws of intestacy. The provision of the Trust Agreement containing that provision was drafted before [redacted] had any children. This would indicate that the grantor of the trust, namely [redacted]'s father, could not have had a clear expectancy that the remainder interest would go to specific individuals. Furthermore, the class of eligible heirs can change at any time. For example, if [redacted] remarries, her new spouse, if he survives her, would be an heir under Texas Probate Law.

The instant situation differs from that described in Rev. Proc. 68-32 in that the grantor-grantee relationship is a father-daughter relationship and not a husband-wife relationship. The default provision is also distinguishable because the provision contained in the revenue procedure arguably refers to the couple's specific children whereas, here, the so-called default provision refers to heirs.

Finally, we note that Rev. Proc. 68-32 refers to a power of appointment, without specifying whether that power is a general or special power of appointment. Hence, it might be argued that such reference could be construed as referring to a special power of appointment, rather than a general power of appointment. As such, Rev. Proc. 68-32 would not be applicable to the instant case since all the parties here agree that the power of appointment is a general one.

Conclusion

Based on the above, we conclude that [redacted]'s interest in the [redacted] can be valued in accordance with recognized actuarial principles. We therefore conclude that she owns a 100 percent interest in the trust for purposes of I.R.C. § 318(a)(2)(B)(i). Accordingly, we reaffirm our conclusion, in our memorandum of February 11, 1992, that [redacted] percent of the common stock of [redacted], which is owned by the [redacted], should be attributed to [redacted].

If you have any questions concerning the above, please contact William Baumer at FTS 622-7930.

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